

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0089
SALES AND USE TAX
FOR TAX PERIODS: 1997

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1. Sales and Use Tax: Difference in Taxable Sales

Authority: IC 6-2.5-2-1, IC 6-2.5-2-2, IC 6-2.5-6-7, IC 6-2.5-6-8.

Taxpayer protests the assessment of gross income tax on receipts which Taxpayer claims constitute exempt agency receipts.

2. Sales and Use Tax: Bad Debt Deductions

Authority: IC 6-2.5-6-9, 26 U.S.C.A. Sec. 166, 26 C.F.R. Sec. 1.166-1 (c).

Taxpayer protests the adjustments made for bad debts.

3. Sales and Use Tax: Marketing Expenses

Authority: 45 IAC 2.2-3-16

Taxpayer protests

4. Tax Administration: Penalty

Authority: IC 6-8.1-10-2.1, 45 IAC 2.2-3-16.

Taxpayer protests the imposition of penalty.

Statement of Facts

Taxpayer is a clothing retailer. After an audit, Taxpayer was assessed additional sales and use tax, interest and penalty for the tax period January 1, 1997 – June 30, 1997. Taxpayer protested the assessment and a hearing was held. More facts will be provided as necessary.

1. Sales and Use Tax: Difference in Taxable Sales

Discussion

Indiana imposes an excise tax, the gross retail tax, on retail transactions made by retail merchants. The merchant, as agent of the state, collects the tax from the purchaser. IC 6-2.5-2-1. The measure of the tax is the total gross retail income received in taxable transactions by the merchant. Tax applies at a rate of 5% of the gross retail income on each taxable transaction, rounded to the nearest whole cent. IC 6-2.5-2-2. The amount of a retail merchant's tax liability is determined pursuant to the following provisions of IC 6-2.5-6-7.

Except as otherwise provided in IC 6-2.5-7 or in this chapter, a retail merchant shall pay to the department, for a particular reporting period, an amount equal to the product of:

- (1) five percent (5%); multiplied by
- (2) the retail merchant's total gross retail income from taxable transactions made during the reporting period.

The amount determined under this section is the retail merchant's state gross retail and use tax liability regardless of the amount of tax he actually collects.

In the audit, the Department Auditor calculated the amount of sales tax due by multiplying Taxpayer's gross retail income as indicated in the sales journals by the tax rate of five percent (5%). Taxpayer testified that its computer registers computed the sales tax charged on each individual sale. The registers then calculated the total amount of sales tax collected on the individual transactions during the month. Taxpayer entered this number on the line on the ST 103 for tax to be paid to the state. Taxpayer then calculated the gross retail sales from this sales tax figure to enter onto the line for gross retail sales on the ST 103. Taxpayer argues, but was unable to substantiate, that the difference in sales tax as determined in the audit and as determined in Taxpayer's filings is attributed to the rounding to the nearest whole cent of tax on the sales tax chart issued by the Department. Taxpayer contends that its process reflects the proper amount of sales tax to be remitted to the state and that the Department process overstated the sales tax to be remitted.

IC 6-2.5-6-8 provides for an "income exclusion ratio" to adjust the sales tax liability. The enactment of this law indicates that the legislature was aware of the discrepancy between the two formulas for determining the sales tax liability.

The method of computation of the proper amount of tax to remit to Indiana is set out at IC 6-2.5-6-7 as previously cited. The Auditor correctly used this statutory procedure to compute Taxpayer's sales tax liability.

Finding

Taxpayer's protest is denied.

2. Sales and Use Tax: Bad Debt Deductions

Discussion

During the tax period, Taxpayer had an agreement with a related factoring company and bank to administer Taxpayer's proprietary credit card program. Taxpayer's customers used credit cards issued in Taxpayer's name to finance purchases at Taxpayer's retail stores. Pursuant to the agreements, Taxpayer sold to the factoring companies the credit slips for the amounts shown thereon less a discount equal to the bad debt percentage incurred in the previous year and the rights to collect on the debts. At the end of each fiscal year the payments were "trued up," i.e., Taxpayer and the factoring company determined the actual amount of bad debt losses arising from credit card transactions during the year and adjusted the payments accordingly. The agreement expressly made Taxpayer responsible for all bad debts with respect to transactions under the agreement. At this point, Taxpayer does not retain recourse against the customers. Taxpayer wrote the bad debts off on their federal adjusted gross income tax returns and claimed the bad debt deduction on their sales tax returns. The bad debt deduction was disallowed in the audit report.

The sales tax law provides for a bad debt deduction at IC 6-2.5-6-9 as follows:

In determining the amount of state gross retail and use taxes which he must remit. . . , a retail merchant shall deduct from his gross retail income from retail transactions made during a particular reporting period, an amount equal to his receivables which:

- (1) Resulted from retail transaction in which the retail merchant did not collect the state gross retail or use tax from the purchaser;
- (2) Resulted from retail transaction on which the retail merchant has previously paid the state gross retail or use tax liability to the department; and
- (3) Were written off as an uncollectible debt for federal tax purposes during the particular reporting period.

In this instance, Taxpayer clearly meets the first two requirements. It paid the sales tax to Indiana but did not ever collect it from the purchaser. The issue to be determined is whether Taxpayer meets the third requirement for the deduction of bad debts.

26 U.S.C.A. Sec. 166 allows for the deduction of a bona fide debt from adjusted gross income tax. The term "bona fide debt" is explained at 26 C.F.R. Sec. 1.166-1 (c) as "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."

In this case, Taxpayer sells the account receivables to another entity. Customers actually owe the debt to the bank. Pursuant to the submitted agreements, the bank has the right to collect the debt from the purchasers of Taxpayer's product. Taxpayer does not have that right. Therefore, Taxpayer has no recourse against the customers who do not fulfill their obligations to satisfy their credit card liabilities. Pursuant to the terms of the federal law and regulations, the bona fide debt is between the customer and the bank. Taxpayer does not have a bona fide debt and cannot write off bad debts for adjusted gross income tax purposes. Taxpayer does not meet the third requirement to deduct bad debts for sales tax purposes.

Finding

Taxpayer's second point of protest is denied.

3. Sales and Use Tax: Marketing Expenses

Discussion

Taxpayer also protests the assessment of use tax on certain expense accounts. These accounts included promotional materials such as banners and statement stuffers that were centrally purchased and stored in Ohio before being distributed to the Indiana stores. Taxpayer contends that it paid use taxes on these accounts pursuant to an audit by Ohio. Taxpayer offered a copy of a check and letter as evidence it had paid the taxes to Ohio. Indiana allows a credit for use taxes paid to another state. 45 IAC 2.2-3-16.

Finding

Taxpayer's protest is sustained subject to audit verification.

4. Tax Administration: Penalty

Discussion

Taxpayer's final point of protest concerns the imposition of the ten per cent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or

inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

In this instance, Taxpayer failed to follow the instructions of the department in the way it reported its sales tax liability. This breach of its duty to properly report and remit sales taxes constitutes negligence.

Finding

Taxpayer's protest is denied.

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